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March 11, 2002

Mr. Timothy S. Lucas
Derivatives Implementation Group Chairman
Financial Accounting Standards Board
401 Merritt 7
PO Box 5116
Norwalk, CT 06856-5116

Dear Mr. Lucas:

We would like to take the opportunity to comment on the tentative conclusions reached by the FASB staff in DIG Implementation Issues B12, "Embedded Derivatives in Beneficial Interests Issued by Qualifying Special-Purpose Entities" (Issue B12) and DZ, "Application of Statement 133 to Beneficial Interests in Securitized Financial Assets" (Issue D2) at the Board meeting on January 30, 2002.

We understand that the Board is considering amendments to FAS 133 that would treat all beneficial interests in a QSPE as debt and would require look-through to the assets of a QSPE to determine whether its beneficial interests contain embedded derivatives. We also understand that the Board is considering amending Issue D2 to apply similar rules to beneficial interests in non-OSPEs.

We believe that such amendments would create (a) significant and unnecessary complexity and uncertainty for investors in QSPEs, (b) significant and unnecessary complexity and uncertainty for non-QSPE issuers and investors, and (c) non-comparability of financial statements of such issuers and investors because of diversity in application. We believe that the Board should not adopt these amendments, but rather should clarify current GAAP for accounting for beneficial interests in both QSPEs and non-QSPEs. In the event the Board does adopt the amendments, we recommend that they apply only to QSPEs and that they grandfather beneficial interests acquired prior to the effective date of the amendments.

## I. OSPEs

From our understanding of the proposal, the look-through model finds embedded derivatives in two ways. In the first way, the holder of a beneficial interest looks for any freestanding derivatives to which the QSPE may be a party. In the second way, the investor tries to determine the implicit claims that it has through the QSPE's structure and cash flows and then treats these implicit claims as if they were the explicit terms of the beneficial interest. The second method attempts to identify implicit derivatives inherent in the structure and assets of the QSPE. Both methods would create considerable complexity and uncertainty in accounting for beneficial interests, resulting in non-comparability of financial statements of different issuers and holders of such interests because of the diversity that will likely exist when bifurcating.

# A. Complexity and Uncertainty

Consider Issue D2, example 4, in which an SPE holds \$1 million of XYZ stock and a 3 year European put on that stock struck at \$1 million. The SPE issues two beneficial interests: a class A interest for \$1 million, which provides a senior claim of \$1.37 million, and a class B residual interest. Issue D2 concludes that the class A interest should be bifurcated into a zero

coupon bond with a face amount of \$1 million, and a purchased call spread on XYZ stock from \$1 million to \$1.37 million (Bifurcation Alternative 1).

If there is an implicit derivative, it is not clear that Issue D2 correctly identifies it. The beneficial interest could also be bifurcated into a zero coupon bond with a face amount of \$1.37 million and a written put spread from \$1.37 million to \$1 million (Bifurcation Alternative 2). The annual income that each alternative produces will differ significantly.

The \$1.37 million zero coupon bond from Bifurcation Alternative 2 will provide 37% more steadily accruing interest income than the \$1 million zero coupon bond from Bifurcation Alternative 1. It is extremely unlikely that the mark to market of the two embedded derivatives would offset this difference in any year. To add to the complexity, there are many other combinations of bonds and derivatives that would match the implicit claims of the class A interest, each with its own unique income pattern. None of these alternatives is any more economically real or inherent in the structure than any other.

The proposed amendments would create other complexities. For example, as a structural matter the put could be viewed as a financial guarantee of a return of \$1 million on the class A debt host. This analysis may exclude the put from FAS 133 under para. 10(d), potentially leading to a different characterization of the terms of the embedded derivative (e.g., a put struck at \$1.37 million rather than a put spread from \$1.37 million to \$1 million.

Would the answer differ if the investors restructured the transaction so that the QSPE does not own the put? The investor in the class A debt host might buy a financial guarantee directly from an insurance company. Would this be a separate financial guarantee? Or would it be treated as a unit with the QSPE's other holdings, returning the parties to the same position as if the QSPE owned the put (compare Issue K1, which treats offsetting loans as a single unit and characterizes them as a swap)? Example 4 is complex and has uncertain accounting consequences under the proposed amendments, and the complexity and uncertainty grow even greater with only slight changes like acquiring the financial guarantee outside of the structure rather than within the OSPE.

## B. Noncomparability of Financial Statements

How should investors determine the proper bifurcation of beneficial interests? Issue B22 provides that in separating an option-based embedded derivative, "the strike price of the embedded derivative should be based on the stated terms documented in the hybrid contract."

<sup>&</sup>lt;sup>1</sup> As a matter of form, one could interpret example 4 as providing that the express terms of the BIs actually define payments by reference to the price of the XYZ stock (i.e., the class A interest actually states that it represents a claim of \$1 million plus any appreciation of the stock from \$1 million to \$1.37 million). In that case, however, the express terms would represent an embedded derivative under the original draft of Issue B12, and one would not need to "peck through" or revise Issue B12. We analyze the example based on the assumption that the Board would conclude that the class A interest consists of a debt host and a call spread even if the express terms of the interest were simply a senior claim of \$1.37 million.

<sup>&</sup>lt;sup>2</sup> DIG Issue B19 provides that in bifurcating an embedded derivative "an entity may not express the characteristics of the debt host contract in a manner that would result in identifying an embedded derivative that is not already clearly present in a hybrid instrument." Among the many combinations of debt and derivatives that can generate the same practical cash flows as the class A interest, none of the derivatives (e.g., the call spread and the put spread) is any more or less "clearly present" in the class A interest.

<sup>&</sup>lt;sup>3</sup> The strike on the put, and the class A interest's senior position, ensures that only the class A investor benefits from the put.

However, where the BI is a fixed income instrument or a residual interest, there are no stated terms on which to base the decision. One could apply Issue B19, and allow each holder to "make its own determination" based on its own "judgment" after considering "the features of the hybrid instrument, the issuer," etc.

However, none of these features clearly indicates the embedded derivative in a fixed income instrument or a residual. Different holders could reasonably choose different methods of bifurcation. As described above, a holder who chose Bifurcation Alternative 1 would report a different amount of interest income and mark to market gain/loss in each year than would a holder who chose Bifurcation Alternative 2. As a result, the two holders' financial statements would report income that differs in both amount and character (interest income v. derivative gains/losses), and their financial statements would not be comparable.

### II. Application to Non-QSPEs

The Board has indicated that the revised Issue B12 would apply only to QSPEs. However, the Board has also indicated that it will amend Issue D2 to apply to non-QSPEs. Will Issue D2 be similar to Issue B12? Will the same model be applied to non-QSPE beneficial interests? Investors may end up applying the same look-through rules by analogy in analyzing interests in non-OSPEs.

Non-QSPEs have the ability to manage their financial assets (or own operating, non-financial assets). Extending the look-through amendments to beneficial interests in non-QSPEs would exponentially increase the complexity, uncertainty, and lack of comparability inherent in look-through accounting and make these problems relevant to the issuer as well as the investors. Consider the complication of determining embedded derivatives for senior, fixed income interests in non-QSPEs in the following cases, which are only a few of many possible structures:

- Closed end stock investment funds that issue short term floating rate perpetual
  preferred stock.<sup>4</sup> Would these preferred shares be bifurcated into a debt host and a
  compound derivative involving a written put on an actively managed stock portfolio
  and interest rates?
- Closed end stock investment funds that issue long term fixed rate perpetual preferred stock.<sup>5</sup> (debt host and written put?)
- Bankruptcy remote SPE owning a power plant that is party to a spot price take or
  pay contract (debt host with compound derivative including electricity rates and
  counterparty credit?)
- Same, but with fixed price take or pay contract (debt host with compound derivative
  of client credit to the extent spot rates are below fixed price?)
- Similar SPEs holding rights to oil production or oil fields
- · Leveraged lease securitizations
- · Any interest in a derivatives product company
- Any nonrecourse loan

When would interests in these entities be debt, and when would they be equity? How would one identify embedded derivatives in debt hosts? In effect, all loans consist of a risk free rate and a written put into the assets of the issuer, because borrowers can always default and leave creditors with only the value of the borrower's assets. The scope of this fact is so broad, and the complications of attempting look-through accounting for such loans are so daunting, that

<sup>&</sup>lt;sup>4</sup> See, for example, 49 day auction preferred stock of the John Hancock Patriot Preferred Dividend Trust.

See, for example, 7 1/4% preferred stock of the Gabelli Equity Trust.

the Board should make clear that investors and issuers should use current GAAP to account for investments in non-OSPEs.

#### III. Existing Models

We believe that existing accounting models can adequately handle many of the potential problems raised by the examples that the Board has discussed.

#### A. Synthetic Credit Linked Notes

Consider an SPE that holds highly rated bonds, writes a credit derivative, and issues one class of beneficial interests that effectively has the characteristics of a synthetic credit linked note. The Board believes that this structure abuses a QSPE to hide a derivative. However, a QSPE may hold only passive derivatives that pertain to beneficial interests held by parties other than the transferor or its affiliates. A derivative only pertains to a beneficial interest if it relates to and counteracts risks associated with the beneficial interests or the transferred assets. A written credit derivative does not counteract such risks, but rather introduces a new risk that has no relation to the beneficial interest or the transferred assets.

Therefore, this structure does not qualify as a QSPE under FAS 140 as it is written today. This entity should never have qualified as a QSPE because the derivative in the entity did not counteract risks, but added risk. Issue B12 would not even apply on its own terms. The written derivative would appear in the issuer's financial statements (and in those of any parent with which it consolidates), so there would be no "hidden" derivative. FAS 140 should be a very effective first line of defense against perceived abusive transactions when appropriately applied for QSPEs.

#### B. Securitization of Assets without Contractual Cash Flows

Accounting for securitizations of assets without contractual cash flows can be easily handled by existing guidance for collateral dependent loans (nonrecourse loans and the like). Under this accounting model, a lender should only accrue interest to the extent that the fair value of the collateral supports the accrual. In the case of Issue D2, example 4, the class A interest holder cannot accrue income under the collateral dependent loan model unless the XYZ stock appreciates in value, because there is only \$1 million of stock collateralizing the return on the \$1 million class A interest. Contrast this with the proposed accounting model of Issue D2, which would allow the holder to accrue income on the imputed zero coupon debt host even if the stock does not appreciate. It is highly unlikely that this income accrual would be offset by a mark to market loss on the bifurcated option in any given year.

Alternatively, the accounting model of EITF 96-12 could be used to account for beneficial interests in QSPEs. The Emerging Issues Task Force has already considered this model and stated that it may be applied to a securitization of assets that do not have contractual cash flows.<sup>8</sup>

### IV. Proposals Would Reverse Existing Guidance

The proposed look-through accounting rules would not simply implement FAS 133. They would require an amendment to FAS 133 that would reverse existing guidance governing the identification of derivatives and embedded derivatives, including both DIG issues and provisions of FAS 133 (for an initial list of affected guidance, see Appendix A).

<sup>6</sup> See FAS 140, para. 35(c)(2).

<sup>&</sup>lt;sup>7</sup> See FAS 140, para. 40(c).

<sup>8</sup> See EITF 99-20, para. 5(b).

## V. Transition

Although we do not believe that look-through is the preferable method of accounting, if the Board disagrees then we suggest that the significance of the changes should determine how they are implemented. Because it would be a significant amendment to existing guidance, it would not be appropriate or practical to apply the changes to beneficial interests acquired (or issued) prior to the effective date of the amendments. Many capital markets participants invested in (or issued) economically valuable beneficial interests in good faith reliance on existing authoritative literature, which they reasonably believed accurately reflects the economics of the transactions.

Applying the proposed changes to previously acquired beneficial interests would be disruptive and impractical to the holders and issuers of beneficial interests (including interests in the multi-trillion dollar asset backed securities market) in a manner similar to holders and issuers of structured notes, which were grandfathered under para. 50 of FAS 133. Just as the Board grandfathered those securities, it should also grandfather beneficial interests in QSPEs and non-SPEs from any look-through accounting rules adopted after their acquisition.

## VI. Closing Remarks

We appreciate your consideration of these views, and we would be happy to discuss them with you at your convenience. If you have any questions about our comments, please call me at (212) 208-3600.

Sincerely,

John Vlahoplus Managing Director

## Appendix A: Existing Guidance That Would Be Reversed

Examples of how the proposed amendments would reverse existing guidance include the following:

- FAS 133, paras. 6 and 7: A contract is a derivative if it has a payout determined by the interaction of an underlying and a notional amount, where the underlying is a price of an asset or the like, but is not the asset itself. These provisions do not apply, for example, to a debt instrument sold for \$1 million that promises to pay \$1.37 million at maturity (such as the terms of the class A interest in Issue D2, example 4). The proposed amendments would alter the application of paras. 6 and 7 to impute underlyings and notionals to BIs by looking through the QSPE.
- FAS 133, para. 60: "If the host contract encompasses a residual interest in an entity, then its economic characteristics and risks should be considered that of an equity instrument..." The proposed amendments would make every residual interest in a OSPE a debt host.<sup>9</sup>
- FAS 133, para. 61(1): convertible preferred stock can be an equity or debt host depending on the terms of the preferred (other than the conversion feature). The proposed amendments would make every preferred interest in a OSPE a debt host.
- FAS 133, para. 309: In determining whether a security has an embedded derivative
  under the rules of FAS 133, para. 13, the test "should be applied based on what is
  possible under the [security's] contractual terms and not on a probability basis."
  (Emphasis added) The proposed amendments require looking through to sources of
  a OSPE's cash flows rather than focusing only on the contractual terms of the BI.
- FAS 133, para. 349: The Board forbids synthetic instrument accounting because it
  conflicts with the goals of transparency and consistency in reporting derivatives at
  fair value. By treating all BIs as debt, and then pecking through only to determine
  implicit terms of the debt, the Board would require users to create synthetic debt
  from instruments that would otherwise be equity.
- FAS 133, para. 435: One cannot recharacterize a fixed rate host contract as
  consisting of a debt host and a floating to fixed interest rate swap or similar
  instrument. The proposed amendments could require such bifurcation of fixed rate
  instruments.
- Issue B12: BI's should be analyzed for embedded derivatives like any other security, focusing "on only the terms and conditions of the beneficial interest and not the detailed holdings of the qualifying SPE." (Emphasis added) The proposed amendments would require a look through to the detailed holdings of the OSPE.
- EITF 99-20 para. 5(b): The Task Force observes that the accounting model of EITF 96-12 "may be applied to those beneficial interests involving securitized financial

The Board's decision to treat all BIs as debt is reportedly based on a view that equity interests cannot be considered equity unless they have equity rights like voting rights (which one cannot have in a QSPE), not merely residual economic returns. We believe that this does not justify the decision, since there are numerous instances of instruments that lack voting rights (like preferred stock, non-voting common stock, etc.) yet are equity for GAAP purposes.

assets that do not involve contractual cash flows." The proposed amendments could instead require derivatives accounting for such BIs.